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Foreign Economic Trends and Their Implications for the United States

JUNE 1989

INDONESIA

FET 89-64
Frequency: Semiannual
Supersedes: 89-28

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International Trade Administration
Washington, D.C. 20230

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INDONESIA - Key Economic Indicators

	1985	1986	1987	1988[a]
Population (million midyear)	165	168	172	175
GDP (billions of Rupiah, 1983 constant prices)	80,119	83,318	86,307	89,932
GDP ($ million)	84,270	69,186	69,362	75,939
GDP per capita ($ at 1987 exchange rate)	348	345	403	448
GDP per capita ($ at prevailing exchange rate)	510	412	403	434
GDP (% growth in constant 1983 rupiah prices)	2.5	4.0	3.6	4.9
Consumer Price Index (1977/78 = 100)	248	263	287	310
Growth in Consumer Prices	4.7	6.0	9.1	8.0
Money Supply (Rps. billion-Dec. 31)	10,104	11,677	12,685	13,300
Foreign Investment Approvals (non-oil) ($ million)	1,107	800	1,240	4,400
Official Int'l Reserves ($ million-Dec. 31)	5,880	5,411	6,512	6,020
External Official Debt (Disbursed - $ million-Dec. 31)	23,887	30,101	35,200	38,360
Debt Service ($ million)	4,037	4,400	5,213	6,200

GOVERNMENT BUDGET (billions of Rupiahs)	FY 86/87 Actual	FY 87/88 Actual	FY 88/89 Budget	FY 89/90 Budget
Routine Expenditures	13,559	17,481	20,066	23,445
Development Expenditures	8,332	9,477	8,897	13,129
Domestic Revenues	16,140	20,803	21,803	25,249
Dev. Receipts (external loans and grants)	5,752	6,158	7,160	11,325

BALANCE OF PAYMENTS ($ million)	FY 85/86 Actual	FY 86/87 Actual	FY 87/88 Actual	FY 88/89 Budget
Overall Balance (change in off. reserves)	160	-469	1,528	297
Current account	-1,832	-4,051	-1,707	-1,941
Exports, Merchandise (F.O.B.)	18,612	13,697	18,343	18,703
Oil and LNG	12,437	6,966	8,841	7,478
Non-oil	6,175	6,731	9,502	11,225
Imports, Merchandise (F.O.B.)	14,200	11,451	12,952	13,799
Oil and LNG sector imports	3,200	2,095	2,355	2,144
Non-oil	11,000	9,356	10,597	11,655

U.S.-Indonesian Trade ($ million)	1985	1986	1987	1988
Indonesian Exports to the U.S.(C.I.F.) [b]	4,040	2,901	3,348	2,563
U.S. Share of Indonesian Exports (%)	21.7	19.6	19.5	16.2
Indonesian Imports from the U.S.(F.O.B.) [b]	1,721	1,482	1,416	1,453
U.S. Share of Indonesian Imports (%)	16.8	13.8	11.3	13.2

--[a] 1988 data are Embassy estimates, except CPI.
--[b] for 1988 through October

Sources: Bank Indonesia, Central Bureau of Statistics, Department of Finance, Investment Coordinating Board, U.S. Department of Commerce, International Monetary Fund and Embassy estimates.

I. Summary

The second half of this decade will be remembered in Indonesia as a period of important economic change. After enduring several difficult years, prompted by a sharp drop in oil prices and a greatly enlarged foreign debt burden, Indonesia is set to end the 1980s and move through the 1990s with a more dynamic and competitive economy. The key to this transformation is the emergence of a competitive private sector. In the past several years the Indonesian Government has laid this foundation through macroeconomic policies, including lean government budgets, curbs on monetary expansion, and maintaining a competitive exchange rate. Second, the Indonesian authorities have implemented a wide range of reforms aimed at restructuring the economy towards greater market orientation. These are known as "deregulation" reforms, because their emphasis is on reducing burdensome regulations.

Indonesia's recent economic performance shows that these policies have paid off: the inflation rate is in single-digits; for the past two years the current account balance deficit has been below $2 billion, well within Indonesia's financing capacity; net transfers of external assistance continue to rise; Indonesia remains current on its foreign debt obligations; and it has maintained a convertible currency for both the current and capital accounts. Moreover, recent data show that real economic activity is recovering. Indonesia's non-oil exports surged to $11.5 billion last year, a 34 percent jump from 1987. Non-oil foreign investment approvals during 1988 amounted to over $4 billion, a two-decade high. Based on these developments, 1988's real GDP growth was probably about 5 percent, the best performance since 1984.

As Indonesia enters the 1990s, the government faces two significant challenges. The first is to create sufficient employment to absorb the 2.3 million new job entrants per year to the work force. The second is to complete and consolidate deregulation reform. Important pockets of protection and import restriction remain, raising costs and penalizing consumers and producers. On both of these issues, the Indonesian Government has given strong positive signals. In his January budget address, President Soeharto stated job creation is the number one priority of Repelita V (the 1989-94 Five Year Plan). The government is fully committed to the process of deregulation, and more deregulation packages are in

preparation. Over the near term, a sharp downturn in the price of oil could once again put pressure on Indonesia's current account balance. Repelita V assumes a moderate $14 per barrel price for this year, rising to $17 by 1994. A similar effect could be triggered by a surge in foreign debt servicing costs, either through a further appreciation of the yen or a steep hike in international interest rates. In the absence of these unexpected external developments, the Indonesian economy should be able to meet many of its Repelita V targets.

II. Recent Developments

From the limited data so far available for 1988, including exports, imports, industrial production, and investment approvals, Indonesia's real GDP is estimated to have grown by around 5 percent last year. This is a significant improvement over the previous three years, when real GDP growth averaged 3.4 percent a year. It translates into a nominal GDP of around Rupiahs 128 billion ($76 billion) and a per capita income of $434.

The inflation rate (Consumer Price Index) for the year, measured as the change in the average monthly index for 1988 over the corresponding figure for 1987, was 8 percent, slightly less than the 9.1 percent of 1987. In the short term, some upward pressure on the inflation front is likely, following recent hikes in the value added tax and increases in electricity tariffs.

In January, President Soeharto used the annual budget message to affirm that his government would closely follow the economic policies laid out in recent years. He emphasized that Indonesia will continue the deregulation process and rely increasingly on the private sector for economic development. Among the projected budget items for FY 1989/90 are:

- Overall revenues are expected to increase by 26 percent to Rupiahs 36,574 billion. Non-oil revenues are projected at Rupiahs 17,350 billion, a 34 percent increase from the previous year. Oil and LNG revenues are expected to total Rupiahs 7,899 billion, down 11 percent from FY 1987/88. Development revenues, consisting of program aid and project aid, are projected to increase by 58 percent to Rupiahs 11,325 billion.

- Expenditures for FY 1989/90 are the same as projected revenues, as required by Indonesian law. Routine expenditures, at Rupiahs 21,445, show a 17 percent increase from FY 1988/89. Like last year, foreign debt servicing is the largest item in this category, totaling Rupiahs 12,236 billion or $7 billion.

- Development expenditures are projected to increase by 48 percent during FY 1989/90 to Rupiahs 13,129 billion. Of this, Rupiahs 9,526 billion are from foreign assistance.

President Soeharto also outlined Repelita V, the 1989-94 development plan, during this year's budget speech. Characterizing Repelita V as the closing stage of Indonesia's first 25-year long-term development plan, President Soeharto urged the nation to strengthen the development foundation already in place in preparation "to enter the take-off process."

Repelita V calls for a 5 percent average annual growth rate, with the agricultural sector growing at 3.6 percent and the industrial sector averaging 8.5 percent growth a year. In order to accomplish this, the plan identifies three broad targets for 1994: to double non-oil exports; to increase government revenues from non-oil sources by 300 percent; and to increase the share of private investment to 45 percent of total. The private sector is to be the primary vehicle for future development, particularly in creating 12 million new jobs -- 2.3 million a year -- to accommodate the new entrants to the labor force.

The economic reforms of the past six months support the goals of Repelita V. The October 1988 deregulation package, the fifth major package during the past five years, contains financial market reforms directed at increasing domestic private savings and net foreign capital inflows. New regulations ease entry and expansion of foreign and domestic banks. They also contain provisions implementing the 15 percent income tax on interest from bank time deposits and certificates of deposits (to be withheld at source), eliminating discrimination against stocks and bonds. The new financial regulations allow state companies to place up to 50 percent of their funds in private banks, a significant departure from the past law which allowed only state banks to hold these deposits.

The trading sector has also been the object of further deregulation. The November 1988 package removed non-tariff barriers on over 300 categories of products, including plastics, iron and steel products, and a variety of agricultural goods. This package also reopened the shipping sector to foreign and domestic new investment, closed since 1976. Additional deregulation measures related to pharmaceuticals, investment and state enterprises are expected soon.

On the taxation side, the Indonesian Government has introduced several changes in the value added tax (VAT) during the first half of this year. VAT billing rates were raised on luxury

goods, such as automobiles, consumer electronic products, and beverages. In addition, almost all services are now subject to a 10 percent VAT. Among the services affected are wholesale, services for oil and natural gas exploration, services supporting mining, repair and maintenance services, leasing services, legal and accounting services, data processing, advertisement, construction and architectural services, transportation services, and franchising.

III. Sectoral Analysis

Energy: Effective January 1, the Indonesian OPEC quota was increased from 1,190,000 to 1,224,000 barrels of crude oil per day (bcd). Year-end production figures show that Indonesia averaged 1,172,000 bcd and an additional 165,000 bcd of condensate in 1988. The average price of Indonesian crude oil (Minas crude) was $15.02, compared with $17.67 for 1987. As a result, exports of oil and gas declined by 10.1 percent in 1988 to $7,690 million.

Mining: After several lackluster years, Indonesia's mineral sector is enjoying a boom. Export values of nickel, copper, and gold are now ahead of tin, traditionally Indonesia's most valuable mineral export. Low recovery costs and expanded production capacity should ensure that this sector is well positioned to take advantage of the current upswing as well as to weather the inevitable cyclical downturns.

The outlook for coal is also promising. Total Indonesian coal reserves are estimated at 28 billion tons, in calorific value more than its reserves in oil and gas. Official projections anticipate coal production to increase from the current 4.5 million tons a year to 15 million tons by the end of Repelita V. The projected increase in coal production is slated to meet the steadily increasing domestic demand from power plants and cement factories, as well as to provide exports.

Manufacturing: The industrial sector has been the main beneficiary of the recent economic reforms. In 1983 industrial production accounted for only 11 percent of GDP. Currently it stands at 15 percent and is projected to increase to 17 percent by the end of Repelita V.

Agriculture: The agricultural sector posted a good year in 1988, as favorable weather enabled recovery from the drought of 1987. Production of rice, the most important food crop, totaled 27 million tons during 1988, up about 3 percent from 1987. The outlook for rice in 1989 is for a record crop, as favorable weather and price conditions stimulate increased rice production.

Repelita V envisions that increasing production of food crops, estate crops and agricultural commodities for export will remain top development priorities. The growth of agricultural processing industries, the livestock and poultry sectors, and forestry and fisheries are also goals. The development budget for agriculture has been increased to almost $1 billion for FY 1989/90, up sharply from under $600 million in FY 1988/89. Funds for agricultural development have largely come from external sources since the 1983 sharp drop in domestic oil revenues.

In 1988 Indonesia's agricultural imports from the United States totaled almost $250 million, up from $185 million in 1987. The increase was led by exports of cotton and soybeans. Exports of Indonesian agricultural products to the United States reached an estimated $1.1 billion in 1988, about the same as the previous year. The exports were led by rubber, wood products, and coffee.

Current topics in the forefront of the agricultural policy debate are continued removal of restrictions on trade, further reduction of agricultural subsidies, diversification in consumption of food grains, the privatization of government owned corporations, and the goal of maintaining rice self-sufficiency versus a broader agricultural self-sufficiency.

Labor: Over the next five years, Indonesia's work force is expected to increase from 74 million to 86 million. Providing employment for these 12 million new job-seekers is one of the most urgent task for the Indonesian Government.

Repelita V calls for a three-pronged approach to tackle the unemployment problem. The first is to control the population growth rate. Over the last 15 years, Indonesia's family planning program has reduced the population growth rate from 2.3 to 2.1 percent; the authorities target a further drop to 1.8 percent by the last year of Repelita V. The second prong involves improving the quality of the work force through greater enrollment in secondary schools, high schools, and universities. Repelita V sets aside Rupiahs 15.7 trillion for construction of schools, vocational schools, and universities. Third are policies intended to stimulate overall economic activity. The Indonesian government calculates that a 5 percent real GDP growth is required each year to absorb the additions to the labor force.

Money and Finance: Indonesia maintains an open capital account, with the Bank Indonesia ready to buy or sell foreign currencies at rates established daily. This is an important factor behind high, and occasionally volatile, interest rates in Indonesia; nominal deposit rates are currently around 16 to 18 percent, 7 to 9 percent after adjusting for inflation.

Over the past year or so, the money supply (M1) has been expanding at a modest 9 to 10 percent range, mostly because of the government's pursuit of monetary policies aimed at maintaining price stability and easing pressures on the balance of payments. Domestic liquidity (M2), however, has been growing at a more rapid 23 to 27 percent rate, due to high Rupiah deposit rates which generated large increases in quasi-money (savings deposits and demand deposits in foreign currency) relative to currency and demand deposits.

IV. Balance of Payments and Foreign Debt

The Indonesian Government's provisional estimate of FY 1988/89 current account deficit is $1.9 billion, up slightly compared with $1.7 billion deficit of FY 1987/88. Non-oil exports during FY 1988/89 are estimated at $11.2 billion, up 17.9 percent from FY 1987/88. Oil and liquid natural gas exports for FY 1988/89 are projected at $7.5 billion, down 15 percent from the previous year. Imports of goods for FY 1988/89 are estimated at $13.8 billion, yielding a balance-of-trade surplus of $4.9 billion. However, this trade surplus is more than offset by a deficit on the services account, largely made up of interest payments on the foreign debt and royalty payments for Indonesia's foreign oil partners under production sharing contracts.

Exports: The non-oil export sector has continued to perform well, almost doubling the value of its exports in three years. The growth in this sector is broadly based; the sector includes traditional commodities such as rubber, palm oil, coffee, and forestry products, as well as manufactured goods, such as garments, fabric, leather goods, paper products, and furniture.

Imports: The government's provisional estimate for FY 1988/89 shows total imports of $13.8 billion, up 6.5 percent from the previous year. This modest import growth in the face of a recovering domestic economy is a reflection of the government's prudent macroeconomic and restructuring policies of the past several years. At the current level, Indonesian imports remain well below the 1981 peak of $23.3 billion.

Official Reserves: Indonesia's official foreign reserves, including gold, SDRs, and foreign exchange, totaled $6,020 million at the end of November 1988, equivalent to around six months of non-oil imports. Indonesia also has around $3,500 million in foreign exchange held by foreign exchange banks, therefore making the total foreign assets of the banking system close to $10 billion. In addition, the government has over $2 billion in undisbursed lines of credit with foreign commercial banks. This high level of reserves is needed because Indonesia maintains a convertible currency and an open capital account.

External Debt: According to government figures, as of December last year Indonesia's official debt totaled $38.4 billion. On top of this, Indonesia owes around $18 billion in private debt, making its total foreign debt around $56 billion, the fourth largest among developing countries. This year, Indonesia will pay around $5 billion in principal payments and $? billion in interest payments, or about 40 percent of its total exports.

Notwithstanding the heavy debt burden, there are a number of positive developments worth noting. First, the share of concessional debt in Indonesia is high compared with other developing countries and the share of debt carrying variable interest rates is low. Second, net transfers of external assistance have risen sharply in recent years while net additional commercial credits have fallen, improving the terms and structure of Indonesia's external debt. Last, all indications are that the growth in debt service will slow down considerably over the next five years, because the enlarged debt burden of the past several years was due to the combination of unusually large repayments coming due on commercial loans from the early 1980s and the sharp appreciation of the yen.

V. Implications for the United States

Economic reforms of the past several years augur well for American businesses investing in Indonesia. Deregulations of 1986-88 have substantially eased restrictions on foreign direct investment. Among important changes are:

- Joint ventures with majority Indonesian ownership are now treated as domestic entities, enabling the joint venture company to distribute their own products locally, borrow from local money market, and invest in sectors open only to domestic companies.

- Any company exporting more than 65 percent of its output can import its material duty free and without license restrictions regardless of availability of comparable domestic products.

- The number of licenses required to operate a business was reduced from four to two. Companies can expand production capacity up to 30 percent without obtaining a license.

- Joint venture companies are permitted to export their own products as well as goods produced by other companies.

Other measures include the recent signing of a bilateral copyright agreement between the United States and Indonesia, which significantly enhances protection of proprietary information for American businesses. The United States-Indonesia bilateral tax treaty, currently waiting for U.S. Senate ratification, should also prove to be beneficial for American companies operating in Indonesia.

During 1988, U.S-Indonesian trade totaled $4.6 billion. U.S. imports from Indonesia (mostly oil, rubber, coffee, plywood, and textile products) totaled $3.5 billion. American exports to Indonesia amounted to $1.1 billion, consisting of agricultural products, resins, aircraft and parts, and earthmoving equipment. Best export prospects for American firms are avionics and ground support equipment, office machines, gasoline and diesel engines, and agricultural and food processing machinery.